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[Home](#) > Debt and Unemployment: Is Global Capitalism Responsible? – Part I

Debt and Unemployment: Is Global Capitalism Responsible? – Part I

Global capital markets have been footloose and fancy free since the 1980s, boosted by rapid globalization in transportation, communication and technology industries. Prowling for profits, investors leap boundaries in an instant, manipulating growth, jobs and industries. In this series, two economists explore global capitalism's growing reach that defies even the world's greatest economic power. In the first article, management professor Jeffrey E. Garten argues that the Obama administration's attempt to reform the financial system misses an essential ingredient – global structure and cooperation. Markets wield more influence than politicians do, acting as arbiters that evaluate every public policy move. Any nation with heavy debt, including the US, is vulnerable, because foreign investors could refuse to lend funds, hiking interest rates and forcing reduced expenditures in services. Some lenders chase short-term profits, while others are wary of excess, demanding sustainable programs. Lacking global tools, nations can only tinker with reform. – YaleGlobal

Politicians propose reforms but it's the global market that disposes
Jeffrey E. Garten
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NEW HAVEN: To dramatize his determination to fight banking excesses, President Obama traveled to a small college near Wall Street on Thursday to chide financial titans and promise tough regulations. Recognizing that US voters are in a populist mood, he urged passage of financial reform legislation. Before the end of summer, Americans can expect to see new laws that address everything from bailout procedures and imposition of new rules for trading of derivatives to tighter consumer protection regarding the sale of complex financial products.

But that does not necessarily mean that the markets driving the globalization frenzy will finally be harnessed. The regulations coming out of Capitol Hill are, on balance, good and necessary, but we should not fool ourselves into thinking that they can tame financial markets with such size, power and global tentacles. Indeed, as current events show, the markets are taming governments, not the other way around. It's the bankers, investors and traders – not men and women in the official seats of power – who wield the most influence.

For months Greece has teetered on the edge of a crisis. Only the threat that markets might push Athens into bankruptcy forced Germany, France and others to put together a serious, concrete bailout package of some €30



Masters of the universe: Americans denounce greedy bankers (above), Greeks protest against hardship

billion. In so doing, the nations not only gave Greece a chance of staying afloat, but stabilized the weakening euro and prevented – for now, at least – the EU itself from destructive internal political tensions. To learn how the drama plays out, forget pronouncements from European statesmen. Instead, watch the interest rates on Greek bonds and the value of the euro, determined by the greed and fear of investors and financial bosses in capital markets.

In May, a historic British election will take place against the backdrop of massive national indebtedness, on one hand, and a

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public clamor for better public services, on the other. Each party claims it can resolve this excruciating dilemma. Fact is, however, party platforms don't matter a wit. Investors and traders of British bonds and currency will set the ultimate financial parameters under which the next English government will operate, and these will determine the success or failure of British policies.

In the US, inevitable increases in interest rates will have more impact on economic growth, employment and the housing market than politicians ever could. Soon collision of America's soaring deficits and debts with investors from abroad will determine what US resources for building the social safety net, taking care of schools and police, and maintaining a strong national defense.

Much of America's debt is held abroad. If foreign investors lose confidence in American policies, they could withhold their funds unless compensated by higher interest rates, meaning the US would have far less to spend. Alternatively, if markets approve of Washington's decisions, more policy options would be available. To measure how well America manages its efforts to reinforce its solvency, don't listen to the Obama administration or Congress; just track the dollar, US interest rates and the movement of capital flows.

Indeed, it will be the movement of currencies, the prices of stocks and bonds, and the cost of credit insurance, or credit default swaps, more than the decisions of parliaments and ministries that will resolve, one way or another, many of the big issues of our time – from reducing debts throughout the Western world, to handling destabilizing global trade and financial imbalances, to shrinking massive overcapacity in such industries as automobiles and telecommunications. Political speeches, high level summits and the like will pale in significance to what the holders and traders in the financial capitals of London, Zurich, New York, Hong Kong or Tokyo think and do.

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The dust is settling from the near meltdown of the global financial system and threat of a 1930s-like depression, For all the

vilification directed at the banks, hedge funds and private equity firms, how ironic that JP Morgan, Deutsche Bank, Credit Suisse and Goldman Sachs – despite the latter’s current legal troubles with the US Securities and Exchange Commission – emerge even more omnipotent.

We have arrived at this point for at least three reasons:

First, the capital market is totally global. With the deregulation of national financial markets and the dismantling of foreign-exchange controls, combined with the growth of real-time communications, international capital flows have grown exponentially, creating hundreds of millions of investors who freely move assets in accordance with their views of government policies. McKinsey & Co. has calculated that between 1990 and 2007, cross-border capital flows increased from \$1.1 trillion, or what was 5.2 percent of global GDP, to \$11.2 trillion, or 20 percent of global GDP. Today, 30 percent of all government bonds, 25 percent of all equity and 20 percent of all corporate bonds are owned by foreign nationals.

Second, politicians have become impotent. The big issues that policymakers face are too complex for any individual to understand or deal with, combining as they do incredibly difficult tradeoffs among various constituencies, short-term horizons necessitated by preserving enough popularity to get re-elected and global considerations – from off-shoring of industry to cheaper locations to exchange rates. Everywhere politicians reflect these handicaps through indecision and political polarization, or through lowest common-denominator compromise.

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Third, global markets alone can act effectively. They can do what politicians cannot – reconcile massive amounts of information quickly and move fast. Right or wrong, they are rarely indecisive. They put an instant price on policies in place of vague rhetoric. They channel excess savings of some people and institutions into sound investments for the future – to build a greener economy, invest in research and development, and fund innovative new business ventures.

Of course, from a public-policy standpoint, there’s another side to the coin. In the last few years, markets have engaged in much mindless speculation, the social value of which is impossible to discern. They exhibited a level of greed, irresponsibility and unaccountability that has led to a drying up of trillions of dollars of economic growth and decimated hundreds of millions of lives.

In the short term, the power of financial markets as disciplinarian and arbiter is likely to increase, particularly if nationalism continues to rise in the US, China, and many big emerging markets such as India and Brazil. In addition, when it comes to serious global financial reform, the prospects are not good, because issues such as reserve levels, bailout procedures and the taxing of banks have created enormous rifts among national governments, all of which have their own set of internal constraints.

Over time, more effective global institutions will be required. But those could be many decades coming.

Given that so many of the challenges individual countries face can only be resolved in a global context, the global markets must reign supreme.

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